Property owners - New tax rules

Changes to Rules for Tax Relief on Mortgage Interest.

In July the government announced that individuals who receive rental income on residential property in the UK or elsewhere, will only be able to claim tax relief on their mortgage interest payments at the basic rate of 20%, rather than their marginal rate, which could be as high as 45%. However, this restriction excludes situations where the property meets all the criteria of a furnished holiday letting.

The new regime is highly complex and the change was far from expected, meaning property owners and tax advisers alike are only just fully coming to terms with its effects.

These changes will mean that all higher-rate tax payers who let property on which there is a large mortgage will pay substantially more tax. Some current basic-rate taxpayers will also be hit by the change as it could push them into the higher-rate bracket.

Those most affected by the changes could potentially see:

- The actual tax they pay on their investment rising twofold or more;
- The tax payable being greater than the rental profits;
- A level of tax which pushes them into a loss, questioning whether their investment remains financially viable.

The main adjustment is the removal of property owner's ability to deduct the cost of their mortgage interest from their rental income when they calculate a profit on which to pay tax, property owners who do not require mortgages will not be affected.

The new rules aim to tax property owners on their turnover rather than their profit, meaning that tax could be payable on non-existent income. Any higher-rate taxpaying landlord whose mortgage interest is 75% or more of their rental income, net of other expenses, will see all of their returns wiped out by 2020. So mortgage costs above 75% of rental income will mean the buy-to-let investments become loss-making.

For additional-rate (45%) taxpayers, the threshold at which their investment returns are wiped out by the tax is when mortgage costs reach 68% of rental income.

The investors worst affected are therefore likely to be those who have bought property recently with large mortgages. Low-yielding properties, such as those in London and other parts of the South East, where rents are comparatively low relative to property prices, will also be exposed. That is because rental income is likely to be lower relative to Investors' mortgage costs.
A recent article in the Telegraph described how one landlord who currently lets a property to a single mother of four, will "not wash its face" once the tax starts to take effect. If he converted the property into two units he could increase the current rent to cover the tax. The council would have to rehouse the family, he said, "and there is already an acute shortage of housing in that area".

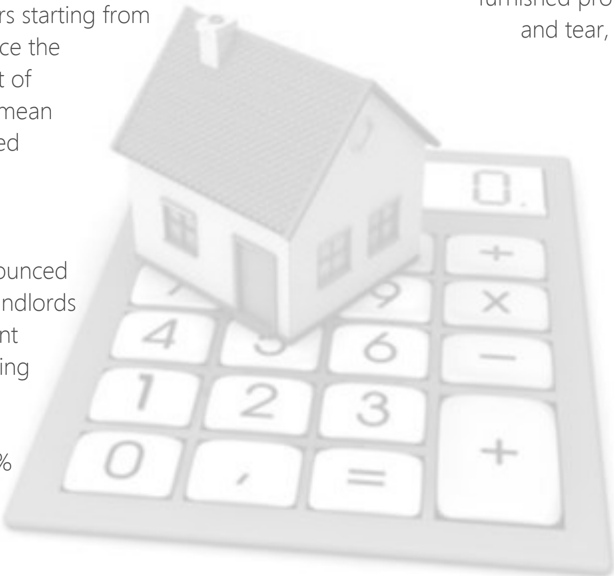
Another landlord described a £110,000 property, on which there is a £68,000 mortgage, let to an elderly couple at "about two thirds of the going market rent", which generates an annual £1,100 profit would fall to £370 after the tax change.

Summer budget 2015 – The new buy-to-let rules

Currently, landlords can deduct costs which they incur when calculating the tax they pay on their rental income. A large portion of these costs are interest payments on the mortgage. Mortgage Interest Relief was withdrawn from homeowners 15 years ago. However, landlords still receive the relief.

The government believe that the ability to deduct these costs puts those investing in a rental property at an advantage. Tax relief for finance costs is particularly beneficial for any wealthier landlords with larger income, as every £1 of finance cost they incur allows them to pay 40p or 45p less tax.

The government are therefore looking to restrict the relief on finance costs which landlords of residential property can get to the basic rate of income tax (20%). The restriction is to be phased in over the next 4 years starting from April 2017. This is aimed to reduce the distorting effect the tax treatment of property has on investment and mean individual landlords are not treated differently based on the rate of income tax that they pay.



The government had earlier announced additional plans to reform how landlords of residential property can account for the costs they incur in improving and maintaining rental property. Currently, landlords of furnished properties are able to deduct 10% of their rent from their profit to account for wear and tear, irrespective of their expenditure. This allows landlords to reduce their tax liability even when they have not improved the property. From April 2016, the government will replace this allowance with a new system enabling all landlords of residential property to only deduct costs which they actually incur in replacing furnishings. Capital allowances will continue to apply for landlords of furnished holiday lets.

Rent-a-Room relief is to be increased from £4,250 to £7,500 a year from April 2016. The value of this relief has been frozen since 1997, so this increase will allow individuals who rent a room in their main residence to do so tax free on income up to £7,500 to reflect increases in rent.

Examples

Below is a worked example of the new tax rules assuming the landlord, pays 40% tax and assuming a buy-to-let earns £20,000 a year and the interest-only mortgage cost is £13,000 a year:

Currently

If a buy-to-let earns £20,000 a year and the interest-only mortgage cost is £13,000 a year. Tax is due on the difference (or profit). So tax would be paid on £7,000, at a 40% tax rate, meaning £2,800 would be paid to HMRC and £4,200 would be kept by the taxpayer.

Another expense which landlords can currently deduct from furnished properties is 10% of the rent charged for wear and tear, even no actual improvements have been made.

By 2020

Tax will be due on the full rental income of £20,000, less a tax credit equivalent to basic-rate tax on the interest. So you pay 40% tax on £20,000 (i.e. £8,000), less the 20% credit (20% of £13,000 = £2,600), meaning £5,400 would be paid to HMRC and £1,600 would be kept by the taxpayer. The taxpayer's tax bill has therefore gone up by 93%.

If Bank Rates (and in turn mortgage rates) rise by a small fraction, lifting the mortgage cost to £15,000, while rent remains at £20,000. £5,000 tax would be due in this scenario, so no profit will be made at all. As stated above, from April 2016 the government will replace the wear and tear allowance with a scheme that ensures landlords can only deduct expenses they actually incur in relation to the property.

Any questions?

If you have any questions on any of the articles covered in this publication or would like our help with any Tax related issues, please contact: Dominic Aspinall on 01204 41 42 43.